

MAR 08 2007

Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF TEXAS  
HOUSTON DIVISION

**H - 07 - 0801**

BRISTOL COUNTY RETIREMENT SYSTEM,  
Individually and On Behalf Of All Others  
Similarly Situated,

Plaintiff,

vs.

HCC INSURANCE HOLDINGS, INC.,  
EDWARD H. ELLIS, JR., STEPHEN L. WAY,  
CHRIS L. MARTIN, and WALTER J. LACK,

Defendants.

Case No.

CLASS ACTION COMPLAINT FOR  
VIOLATIONS OF THE FEDERAL  
SECURITIES LAWS

**JURY TRIAL DEMANDED**

Plaintiff alleges the following based upon the investigation of plaintiff's counsel, which included a review of United States Securities and Exchange Commission ("SEC") filings by HCC Insurance Holdings, Inc. ("HCC" or the "Company"), as well as regulatory filings and reports, securities analysts reports and advisories about the Company, press releases, and media reports about the Company, and plaintiff believes that substantial additional evidentiary support will exist for the allegations set forth herein after a reasonable opportunity for discovery.

**NATURE OF THE ACTION AND SUMMARY OF ALLEGATIONS**

1. This is a class action on behalf of all persons and entities who purchased or otherwise acquired the securities of HCC, a Houston-based insurance company, between May 3, 2005 to Nov. 17, 2006, inclusive, (the "Class Period"), and shareholders of record on April 3, 2006, and who were damaged thereby, seeking to pursue remedies under the Securities Exchange Act of 1934 (the "Exchange Act").

2. HCC has recently admitted in an SEC filing that its previously reported financial results were artificially inflated as a result of an improper stock option backdating

scheme perpetrated at the highest level of the Company. According to the Company, its CEO during the Class Period deliberately orchestrated the scheme with the aid of the Company's General Counsel. Of the CEO, the Company stated that he "should have known he was granting options in a manner that conflicted with our stock option plans and public statements, and that this constituted a failure to align the stock option granting process with our stock option plans and public statements." The Company further reported that its highest-ranking legal officer during the Class Period "was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document our Compensation Committee's informal delegation of authority to [the CEO]."

3. Defendants were personally motivated to engage in the wrongdoing alleged herein in order to make their option grants more valuable and to sell their personally held HCC stock at prices that were artificially inflated by defendants' false statements. Defendant Way (former CEO) sold over 1.7 million shares, grossing more than \$57 million. Defendant Lack (former Chairman of the Compensation Committee) sold 50,000 shares for over \$1.4 million. Defendant Ellis (former CFO) sold 60,000 shares for \$2.3 million, and defendant Martin (former general counsel) sold 20,706 shares for \$676,000. In addition, the wrongdoing allowed HCC to profit by selling stock in a follow-on offering. On November 22, 2005, HCC sold 4,687,500 shares of HCC common stock at \$32.05 per share, a price higher than if the Company's financial results were not artificially inflated.

4. This action seeks to recover the massive investor losses caused by defendants' violation of the federal securities laws.

5. The scheme came to light on November 17, 2006. On that date, after the market closed, the Company announced that it had backdated option grant dates from 1997 through 2006 and that it would restate financial reports previously filed with the SEC and disseminated to investors in press releases. With this admission, HCC joined the large and growing list of companies embroiled in the headline-grabbing option backdating scandal.

6. In response to this announcement, the price of HCC common stock dropped materially, falling from a close of \$31.64 per share on November 17, 2006 to a low of \$28.81, on November 20, 2006 (the next trading day), a one day drop of 9% on volume of 6.6 million shares, which is many times the stocks' average daily trading volume.

7. That same day, the Company announced that Stephen L. Way resigned as CEO and that Chris L. Martin resigned as general counsel.

8. The SEC is investigating the Company with respect to these matters.

### **Introduction to Improper Option Backdating**

9. Under certain circumstances, publicly traded companies may award their officers, employees and directors stock option grants. A stock option grant provides an "optionee" with the right to purchase shares of a company at a specific price – the "exercise price" or "strike price" – on or after a determined date. For instance, if a company grants an employee 10 options with an exercise price of \$5 per share, the employee can buy 10 shares for a total of \$50, regardless of what the market price of the Company's stock is on the date the options are exercised. One of the advantages for investors of this form of compensation, as opposed to straight payments of cash, is that typically it aligns the interests of employees, management and/or directors with the company's shareholders in that the options can only be exercised when the company's stock price rises and reaches the exercise price.

10. When a company grants an employee or a director stock options, it must do so under a written stock option plan filed with the SEC and disclosed to the public. This is so because potential gains, such as the one described above, are a form of risk-based compensation and, therefore, may have an impact on, among other things, the company's compensation expense, earnings per share, and net income. Thus, it is imperative that when a company awards option grants to its employees, management and directors, it does so in compliance with its publicly filed stock option plan and that it appropriately accounts for such grants—particularly when the grants create an expense for the company. The consequence of a company's improper accounting for option grants is that investors, such as HCC's shareholders, will not have an accurate picture of the company's financial position, which is why the Company was forced to restate its previously disseminated financial results.

11. Specifically, under accounting rules in effect at the time, public companies in the United States were permitted to grant stock options to employees without recording an expense as long as the options' strike price was at or above the market's closing price for the stock on the day the options were granted. However, if the option granted was priced below the market price on the date granted, known as an "in the money" options grant, SEC regulations required that any publicly traded company recognize and record the difference as a compensation expense in their financial statements. *See* APB 25, superseded as of December 31, 2005 by FAS 123(R). Accounting rules also require that companies recognize the same compensation expense if "in the money" options were granted to non-employees. Thus, while "in the money" stock options are more valuable to those to whom they are granted, the additional expenses, if reported, would reduce the total amount of net income and earnings per share reported to shareholders of a publicly traded company. As alleged herein, HCC

improperly failed to record these expenses, thereby misleading investors about the Company's true results.

### **JURISDICTION AND VENUE**

12. The claims asserted herein arise under and pursuant to Sections 10(b) and 20(a) of the Exchange Act [15 U.S.C. §§ 78j(b) and 78t(a)], and Rule 10b-5 promulgated thereunder by the SEC [17 C.F.R. § 240.10b-5].

13. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §§ 1331 and 1337 and Section 27 of the Exchange Act [15 U.S.C. § 78aa].

14. Venue is proper in this District pursuant to Section 27 of the Exchange Act, and 28 U.S.C. § 1391(b). Because HCC is headquartered in this District, many of the acts charged herein, including the preparation and dissemination of materially false and misleading information, occurred in substantial part in this District.

15. In connection with the acts alleged in this complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications and the facilities of the New York Stock Exchange ("NYSE").

### **PARTIES**

16. Plaintiff Bristol County Retirement System purchased HCC common stock during the Class Period, as set forth in its certification, annexed hereto, and was injured economically as alleged herein.

17. Defendant HCC is organized under the laws of Delaware and is headquartered at 13403 Northwest Freeway, Houston, Texas 77040-6094.

18. Defendant Stephen L. Way served as HCC's Chief Executive Officer during the Class Period.

19. Defendant Christopher L. Martin served as HCC's General Counsel during the Class Period.

20. Defendant Edward H. Ellis, Jr. served as HCC's Chief Financial Officer during the Class Period.

21. Defendant Walter J. Lack served as Chairman of the Compensation Committee during the Class Period.

22. Defendants Way, Martin, Ellis and Lack are collectively referred to herein as the "Individual Defendants."

23. Because of the Individual Defendants' positions with the Company, they had access to the adverse undisclosed information about its business, operations, products, operational trends, financial statements, markets and present and future business prospects via access to internal corporate documents (including the Company's operating plans, budgets and forecasts and reports of actual operations compared thereto), conversations and connections with other corporate officers and employees, attendance at management and Board of Directors meetings and committees thereof and via reports and other information provided to them in connection therewith.

24. It is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the false, misleading and incomplete information conveyed in the Company's public filings, press releases and other publications as alleged herein are the collective actions of the narrowly defined group of defendants identified above. Each of the above officers of HCC, by virtue of their high-level positions with the Company, directly participated in the management of the Company, was directly involved in the day-to-day operations of the Company at the highest levels and was privy to confidential proprietary information concerning the Company and its business, operations, products, growth, financial

statements, and financial condition, as alleged herein. Said defendants were involved in drafting, producing, reviewing and/or disseminating the false and misleading statements and information alleged herein, were aware, or recklessly disregarded, that the false and misleading statements were being issued regarding the Company, and approved or ratified these statements, in violation of the federal securities laws.

25. As officers and controlling persons of a publicly-held company whose common stock was, and is, registered with the SEC pursuant to the Exchange Act, traded on the NYSE during the Class Period, and governed by the provisions of the federal securities laws, the Individual Defendants each had a duty to disseminate promptly, accurate and truthful information with respect to the Company's financial condition and performance, growth, operations, financial statements, business, products, markets, management, earnings and present and future business prospects, and to correct any previously-issued statements that had become materially misleading or untrue, so that the market price of the Company's publicly-traded securities would be based upon truthful and accurate information. The Individual Defendants' misrepresentations and omissions during the Class Period violated these specific requirements and obligations.

26. The Individual Defendants participated in the drafting, preparation, and/or approval of the various public reports and other communications complained of herein and were aware of, or recklessly disregarded, the misstatements contained therein and omissions therefrom, and were aware of their materially false and misleading nature. Because of their Board membership and/or executive and managerial positions with HCC, each of the Individual Defendants had access to the adverse undisclosed information about HCC's business prospects and financial condition and performance as particularized herein and knew (or recklessly disregarded) that these adverse facts rendered the positive representations made

by or about HCC and its business issued or adopted by the Company materially false and misleading.

27. The Individual Defendants, because of their positions of control and authority as officers and/or directors of the Company, were able to and did control the content of the various SEC filings, press releases and other public statements pertaining to the Company during the Class Period. Each Individual Defendant was provided with copies of the documents alleged herein to be misleading prior to or shortly after their issuance and/or had the ability and/or opportunity to prevent their issuance or cause them to be corrected. Accordingly, each of the Individual Defendants is responsible for the accuracy of the public reports and releases detailed herein and is therefore primarily liable for the representations contained therein.

28. Each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of HCC common stock by disseminating materially false and misleading statements and/or concealing material adverse facts. The scheme: (i) deceived the investing public regarding HCC's business, finances, financial statements and the intrinsic value of HCC common stock; and (ii) caused plaintiff and other members of the Class to purchase HCC securities at artificially inflated prices.

#### **PLAINTIFF'S CLASS ACTION ALLEGATIONS**

29. Plaintiff brings this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of a Class, consisting of all those who purchased or otherwise acquired the securities of HCC between May 3, 2005 to Nov. 17, 2006, inclusive, and shareholders of record on April 3, 2006, and who were damaged thereby. Excluded from the Class are defendants, the officers and directors of the Company, at all relevant times,

members of their immediate families and their legal representatives, heirs, successors or assigns and any entity in which defendants have or had a controlling interest.

30. The members of the Class are so numerous that joinder of all members is impracticable. During the Class Period, there were approximately 111 million shares of HCC common stock outstanding that were actively traded on the New York Stock Exchange. While the exact number of Class members is unknown to plaintiff at this time and can only be ascertained through appropriate discovery, plaintiff believes that there are hundreds or thousands of members in the proposed Class. Record owners and other members of the Class may be identified from records maintained by HCC or its transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

31. Plaintiff's claims are typical of the claims of the members of the Class as all members of the Class are similarly affected by defendants' wrongful conduct in violation of federal law that is complained of herein.

32. Plaintiff will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class and securities litigation.

33. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Class are:

a. whether the federal securities laws were violated by defendants' acts as alleged herein;

b. whether statements made by defendants to the investing public during the Class Period misrepresented material facts about the business, operations and financial statements of HCC; and

c. to what extent the members of the Class have sustained damages and the proper measure of damages.

34. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. Furthermore, as the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for members of the Class to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

### **SUBSTANTIVE ALLEGATIONS**

#### **Materially False And Misleading Statements Made During The Class Period**

35. The Class Period begins on May 3, 2005. On that date, HCC issued a press release announcing “record results” for the first quarter of 2005, and touting the significant increase in net earnings:

Net earnings increased significantly for the first quarter of 2005 rising 29% to \$57.3 million from \$44.6 million for the first quarter of 2004. During the same period, net earnings per diluted share grew 19% to \$0.81 per share from \$0.68 per share, despite approximately \$0.05 earnings per share dilution primarily from the Company’s December 2004 equity offering.

Defendant Way attributed the results to the Company’s underwriting activities that were performing ahead of plan:

Stephen L. Way, Chairman and Chief Executive Officer, said, “Our first quarter results reflect the profitable growth and strong margins from our underwriting activities which are at a pace somewhat ahead of our business plan.”

36. On May 10, 2005, HCC filed its first quarter 2005 report with the SEC on Form 10-Q. The report was signed by defendants Way and Ellis. The Company reported revenues of \$379,678,000, net earnings per share of \$0.81 and shareholders' equity of \$1,402,883,000 for the quarter. In a section of the report titled "basis of presentation" defendants represented that the financial information is presented in accordance with GAAP and fairly present the Company's performance:

#### Basis of Presentation

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments which, in our opinion, are necessary for a fair presentation of the results of the interim periods.

37. The report described the Company's valuation of employee stock options as follows:

#### Stock Options

We account for stock options granted to employees using the intrinsic value method, in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. All options have been granted at fixed exercise prices at the market price of our common stock on the grant date. Thus, no stock-based employee compensation expense is reflected in our reported net earnings. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net earnings and earnings per share if we had used the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation.

38. The report contained certifications signed by defendants Way and Ellis, respectively, representing that the information contained in the report was true, that it did not omit material facts, and that the Company's disclosure controls and procedures were adequate:

1. I have reviewed this quarterly report on Form 10-Q of HCC Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

39. On August 9, 2005, HCC filed its second quarter 2005 report with the SEC on Form 10-Q. The report was signed by defendants Way and Ellis. For the quarter, the

Company reported revenues of \$404,837,000 net earnings of \$0.59 per share and shareholders' equity of \$6,185,072,000. In a section of the report titled "basis of presentation" defendants represented that the financial information is presented in accordance with GAAP and fairly present the Company's performance:

#### Basis of Presentation

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments which, in our opinion, are necessary for a fair presentation of the results of the interim periods.

40. The report described the Company's valuation of employee stock options as follows:

#### Stock Options

We account for stock options granted to employees using the intrinsic value method, in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. All options have been granted at fixed exercise prices at the market price of our common stock on the grant date. Thus, no stock-based employee compensation expense is reflected in our reported net earnings. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net earnings and earnings per share if we had used the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation.

41. The report contained certifications signed by defendants Way and Ellis, respectively, representing that the information contained in the report was true, that it did not omit material facts, and that the Company's disclosure controls and procedures were adequate:

1. I have reviewed this quarterly report on Form 10-Q of HCC Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition,

results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

42. On November 8, 2005, HCC filed its quarterly report for the third quarter of 2005 on Form 10-Q with the SEC. The report was signed by defendants Way and Ellis. For the quarter, the Company reported revenues of \$412,031,000 net earnings of \$0.07

per share and shareholders' equity of \$6,628,933,000. In a section of the report titled "basis of presentation" defendants represented that the financial information is presented in accordance with GAAP and fairly present the Company's performance:

#### Basis of Presentation

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments which, in our opinion, are necessary for a fair presentation of the results of the interim periods.

43. The report described the Company's valuation of employee stock options as follows:

#### Stock Options

We account for stock options granted to employees using the intrinsic value method, in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. All options have been granted at fixed exercise prices at the market price of our common stock on the grant date and no options have been repriced. Thus, no stock-based employee compensation expense is reflected in our reported net earnings. Options vest over a period of up to seven years and expire four to ten years after grant date. During the nine months ended September 30, 2005, we issued 2.2 million shares of our common stock and generated \$32.7 million of cash from options exercised. In accordance with our policy of periodically granting options to our employees, during the third quarter of 2005 we granted 2.9 million options to purchase our common stock at market prices ranging from \$25.88 to \$27.02, and vesting over three to five years.

44. The report contained certifications signed by defendants Way and Ellis, respectively, representing that the information contained in the report was true, that it did not omit material facts, and that the Company's disclosure controls and procedures were adequate:

1. I have reviewed this quarterly report on Form 10-Q of HCC Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition,

results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

45. On November 22, 2005, HCC filed with the SEC a registration and prospectus (collectively, "Prospectus") for the offering of 4,687,500 shares of HCC common stock at \$32.05 per share. The Prospectus presented the Company's results of operations for

the first quarter of 2005, which matched the results as presented in the Form 10-Q for that quarter. In addition, the Prospectus expressly incorporated by reference the three quarterly reports referenced above:

The documents referred to under "Where You Can Find More Information" in the accompanying prospectus that are incorporated by reference into the prospectus and this prospectus supplement include the following documents filed by us with the SEC since the date of the prospectus:

- Our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2005, June 30, 2005 and September 30, 2005;

46. On March 16, 2006, defendants filed HCC's 2005 annual report on Form 10-K with the SEC. The report was signed by defendants Way and Ellis. For the year, HCC reported revenues of \$1,644,342,000, earnings of \$1.79 per share, and shareholders' equity of \$7,084,472,000. In a section of the report titled "Management's Responsibility for Financial Reporting", defendants represented that "We prepared the accompanying consolidated financial statements in accordance with accounting principles generally accepted in the United States of America."

47. Defendants reported in the Form 10-K that HCC accounts for its stock options grants pursuant to APB No. 25, that all options were granted with a strike price equal to the market price on the day of grant and, therefore, that no compensation expense was recognized:

We account for stock options granted to employees using the intrinsic value method, in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. All options were granted at fixed exercise prices at the market price of our common stock on the grant date and no options have been repriced. Thus, no stock-based compensation expense is reflected in our reported net earnings. Options vest over a period of up to seven years and expire four to ten years after grant date.

48. The report contained certifications signed by defendants Way and Ellis, respectively, representing that the information contained in the report was true, that it did not omit material facts, and that the Company's disclosure controls and procedures were adequate:

1. I have reviewed this annual report on Form 10-K of HCC Insurance Holdings, Inc;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors

and the audit committee of registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

49. The statements referenced above in ¶¶ 35-48, were materially false and misleading because they failed to disclose that:

a. defendants backdated stock options grants, such that the description of the Company's granting practices in the financial reports and Prospectus were untrue;

b. HCC's accounting for stock options grants was not made pursuant to APB No. 25, as the Company represented;

c. the Company's reported earnings and shareholders' equity was artificially inflated in each of the financial reports, and Prospectus, discussed above because the Company understated its compensation expense;

d. the Company's reported results were not presented in accordance with Generally Accepted Accounting Principles ("GAAP") and were, in fact, artificially inflated and did not accurately present the Company's actual performance;

e. HCC's financial reports were false and misleading, contrary to the assurances made in the certifications signed by defendants Way and Ellis;

f. The Company's disclosure controls and procedures were inadequate and allowed the backdating scheme to flourish for years, contrary to defendant Way and Ellis' assurances to the contrary.

50. On April 14, 2006, HCC filed its proxy statement with the SEC, and mailed it to HCC shareholders (the "Proxy Statement"). The Proxy Statement solicited proxies from shareholders for the 2006 election of board members. Among other things, the Proxy Statement included the report of the Compensation Committee, which described HCC's executive compensation policies, representing that HCC's stock option plan created value for shareholders:

All decisions by the Compensation Committee relating to the compensation of HCC's executive officers are reviewed by the full Board of Directors. The philosophy of HCC's compensation program is to employ, retain and reward executives capable of leading HCC in achieving its business objectives. These objectives include creating and then preserving strong financial performance, increasing HCC's assets, positioning HCC's assets and business operations in geographic markets and industry segments offering long-term growth opportunities, enhancing shareholder value, and ensuring HCC's survival. The accomplishment of these objectives is measured against conditions prevalent in the industry within which HCC operates.

\*\*\*

Compensation paid to executive officers is based upon a company-wide salary structure consistent for each position relative to its authority and responsibility compared to industry peers. *Stock option awards have historically been used to reward executive officers and to retain them through the potential of capital gains and equity buildup in HCC. In 2005, the number of stock options granted, whether in conjunction with a written employment agreement or otherwise, was determined by the subjective evaluation of the executive's ability to influence HCC's long-term growth and profitability. The Board of Directors believes the award of equity-based incentives such as stock options represents an effective incentive to create value for the shareholders.*

51. The Proxy Statement detailed the following stock option grants to executives in 2005:

#### OPTIONS/SAR GRANTS IN LAST FISCAL YEAR

Name	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Share Price Appreciation for Option Term (1)	
	Number of Securities Underlying Options Granted	Percent of Total Options Granted to Employees In Fiscal Year	Exercise or Base Price Per Share	Expiration Date	5%	10%
Stephen L. Way	600,000	15.73%	\$ 25.88	7/22/2011	\$5,281,005	\$11,980,799
Edward H. Ellis, Jr.	100,000	2.62%	\$ 27.02	9/28/2011	\$ 918,938	\$ 2,084,758
Craig J. Kelbel	100,000	2.62%	\$ 27.02	9/28/2011	\$ 918,938	\$ 2,084,758
	112,500	2.95%	\$ 23.70	12/31/2010	\$ 906,780	\$ 2,057,175
Christopher L. Martin	75,000	1.97%	\$ 27.02	9/28/2011	\$ 689,204	\$ 1,563,568
Michael J. Schell	100,000	2.62%	\$ 27.02	9/28/2011	\$ 918,938	\$ 2,084,758

52. The statements referenced above in ¶¶ 50-51, were materially false and misleading for the reasons set forth in ¶49, namely, because they failed to disclose that executives, and other HCC employees, received backdated stock option grants that made them much more valuable to recipients than if the strike prices had been selected on the actual grant date. Such practices did not “create value for shareholders.” To the contrary, backdating options undermines the very purpose of option grants, which is to motivate recipients to perform their duties well so that the Company’s operations improve and drive the stock price up. By backdating the options to a time when the price was lower than at the time the options were actually granted, the granted options were closer to the money or, in many instances, in the money, thereby making them valuable in spite of the stock price’s actual performance.

53. On May 10, 2006, HCC filed its report for the first quarter of 2006 on Form 10-Q with the SEC. The report was signed by defendants Way and Ellis. For the quarter, the Company reported revenues of \$466,072,000, net earnings of \$0.71 per share and shareholders’ equity of \$1,758,303,000. In a section of the report titled “basis of presentation” defendants represented that the financial information is presented in accordance with GAAP and fairly present the Company’s performance:

*Basis of Presentation*

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries.

54. The report described the Company’s valuation of employee stock options as follows:

STOCK OPTIONS

Our stock option plans, the 2004 Flexible Incentive Plan and 2001 Flexible Incentive Plan, are administered by the Compensation Committee of the Board of Directors. Options granted under these plans may be used to purchase one share of our common stock. All options are granted at fixed exercise prices at the market price of our common stock on the grant date and no options have been repriced. Options vest over a period of up to seven years, which is the requisite service period, and expire four to ten years after grant date.

55. The report contained certifications signed by defendants Way and Ellis, respectively, representing that the information contained in the report was true, that it did not omit material facts, and that the Company's disclosure controls and procedures were adequate:

1. I have reviewed this quarterly report on Form 10-Q of HCC Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

56. On August 3, 2006, HCC issued a press release announcing "record half year results," and reporting the following results of operations:

Net earnings increased substantially during the second quarter of 2006, rising 40% to \$89.5 million from \$64.1 million and net earnings per diluted share grew 31% to \$0.77 per diluted share from \$0.59 per share, both compared to the same period in 2005.

\*\*\*

Total revenue grew substantially during the first six months of 2006, rising 22% to \$959.3 million from \$784.5 million in the corresponding period in 2005. This increase was primarily from growth of earned premium due to our increased retentions.

57. On August 9, 2006, HCC filed a Form 8-K with the SEC announcing that it would delay the filing of its second quarter 2006 Form 10-Q during the pendency of an independent review of its stock option granting practices. According to the Company, "in some instances the grant date may differ from the date used to record certain prior option grants, which could mean those grants may have been recorded incorrectly." The Company did not admit to any wrongdoing and did not detail the persons involved with the backdating.

58. The statements referenced above in ¶¶ 53-57, were materially false and misleading because they failed to disclose that:

- a. defendants backdated stock options grants, such that the description of the Company's granting practices in the financial reports were untrue;
- b. the Company's reported earnings and shareholders' equity was artificially inflated in each of the financial reports, and second quarter of 2006 earnings press release, because the Company understated its compensation expense;
- c. the Company's reported results were not presented in accordance with GAAP and were, in fact, artificially inflated and did not accurately present the Company's actual performance;
- d. HCC's financial reports were false and misleading, contrary to the assurances made in the certifications signed by defendants Way and Ellis;
- e. The Company's disclosure controls and procedures were inadequate and allowed the backdating scheme to flourish for years, contrary to defendant Way and Ellis' assurances to the contrary.

### **THE TRUTH BEGINS TO EMERGE**

59. The Company revealed the previously concealed information on November 17, 2006, after the close of ordinary trading. On that date, the Company announced that it had backdated option grant dates from 1997 through 2006 and that it would restate financial reports previously filed with the SEC. It was also announced that defendant Way resigned as the Company's CEO, while defendant Ellis resigned as CFO. In relevant part, the Company stated as follows:

The investigation has concluded that the Company used incorrect measurement dates for certain stock option grants covering a significant number of employees during the period from 1995 through 2006. The Company and the Special Committee are working with their advisors to determine the appropriate measurement dates and assess the related financial effects. LECG currently estimates the cumulative pre-tax financial impact of recording additional non-cash charges associated with stock option grants is not likely to exceed \$37 million spread over the vesting periods of the options in question. The Company expects that the errors will require some increased tax provision. The Company

is currently evaluating LECG's estimate for the financial impact and the related tax impact. Upon completion of this evaluation, the Company will determine whether a restatement of certain previously filed financial statements will be required. The Company intends to continue cooperating with the SEC in connection with its informal inquiry into this matter.

Stephen L. Way has resigned as Chief Executive Officer effective November 17, 2006. Mr. Way will remain a director of the Company and serve as the non-executive Chairman of the Board of Directors.

60. In response to this announcement, the price of HCC common stock dropped materially, falling from a close of \$31.64 on November 17, 2006 to a low of \$28.81, on November 20, 2006 (the next trading day), a one day drop of 9% on volume of 6.6 million shares, which is many times the stocks average daily trading volume.

#### **SUBSEQUENT ADMISSIONS**

61. On December 10, 2006, HCC announced that it would restate its previously filed financial statements to correct for accounting errors caused by the backdating scheme, which was said to involve a majority of HCC's options grants, stating as follows:

As previously announced, a Special Committee of the Board of Directors of the Company is conducting a review of the Company's historical stock option grants with the assistance of independent legal and forensic accounting experts. On November 17, 2006, HCC announced that the Special Committee had made certain determinations as a result of its review of our past stock option granting practices. The Special Committee found HCC used incorrect accounting measurement dates for certain stock option grants covering *a significant* number of employees during the period 1997 through 2005 and that *the majority of these option grants were retroactively priced*. Additionally, incorrect measurement dates due to retroactive pricing were found to exist in 2006. In substantially all of such instances, the price on the correct measurement date was higher than the price on the stated grant date. Thus recipients of the options could exercise at a strike price lower than the correct measurement date price. The difference in the measurement dates will result in non-cash stock-based compensation expense. As a result of the review, the Company accepted the resignation of certain members of management. [Emphasis added].

62. Then, on December 27, 2006, HCC filed an Amended Form 10-K, which restated the Company's previously filed financial results from 1997 to 2006, as follows (all amounts in thousands):

	Net earnings as previously reported	Non-cash stock option compensation expense	Other	Tax effect	Total adjustments	Net earnings as restated
Years ended December 31,						
1997	\$ 50,083	\$ (3,789)	\$ —	\$ 1,326	\$ (2,463)	\$ 47,620
1998	73,110	(3,664)	—	1,273	(2,391)	70,719
1999	26,572	(1,474)	—	(148)	(1,622)	24,950
2000	55,468	(4,586)	(1,124)	1,830	(3,880)	51,588
2001	30,197	(2,201)	1,881	88	(232)	29,965
2002	105,828	(2,043)	(27)	561	(1,509)	104,319
Cumulative effect at December 31,						
2002	341,258	(17,757)	730	4,930	(12,097)	329,161
2003	143,561	(3,279)	1,270	475	(1,534)	142,027
2004	163,025	(2,571)	2,453	(208)	(326)	162,699
2005	195,860	(3,001)	(3,137)	1,470	(4,668)	191,192
Cumulative effect at December 31, 2005	\$ 843,704	\$ (26,608)	\$ 1,316	\$ 6,667	\$ (18,625)	\$ 825,079

63. The Amended Form 10-K also discussed the findings of the investigation. Shockingly, the Company found that the scheme was pervasive, affecting all levels of employees, and was spearheaded by defendant Way, the former CEO, and defendant Martin, the Company's general counsel:

The voluntary review by our management concluded that the actual accounting measurement dates for certain past stock option grants differed from the originally stated grant dates, which were also utilized as the measurement dates for such awards. In August 2006, our Board of Directors formed a Special Committee of independent directors to commence an investigation of our past stock option granting practices for the period 1995 through 2005. The Special Committee was composed of the members of the Audit Committee of the Board of Directors. The Special Committee retained the law firm of Skadden, Arps, Slate, Meagher & Flom, LLP as its independent legal counsel and LECG as forensic accountants to aid in the investigation.

On November 17, 2006, we announced that the Special Committee had made certain determinations as a result of its review of our past stock option granting practices. The

Special Committee found that we had used incorrect accounting measurement dates for stock option grants covering a significant number of employees and members of our Board of Directors during the period 1997 through 2005 and that certain option grants were retroactively priced. Additionally, at the direction of the Special Committee, we reviewed our stock option granting practices from 1992, the year of our initial public stock offering, through 1994 and in 2006 and found incorrect measurement dates due to retroactive pricing were used in 2006. In substantially all of these instances, the price on the actual measurement date was higher than the price on the stated grant date; thus recipients of the options could exercise at a strike price lower than the actual measurement date price. To determine the actual measurement dates, the Special Committee utilized the following sources of information:

- The dates on documentation such as e-mails, regulatory form filings, acquisition agreements and other correspondence;
- The date that the relevant stock option grant was entered into Equity Edge, our stock option tracking and accounting system;
- Requirements of Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees, and related interpretations; and
- Guidance from the Office of Chief Accountant of the Securities and Exchange Commission (SEC) contained in a letter dated September 19, 2006.

The Special Committee concluded that mis-priced option grants, the effect of which, together with certain other adjustments, resulted in a cumulative net decrease in shareholders' equity at December 31, 2005 of \$3.3 million, *affected all levels of employees. The Special Committee found that Stephen L. Way, Chief Executive Officer, retroactively priced options, that he should have known he was granting options in a manner that conflicted with our stock option plans and public statements, and that this constituted a failure to align the stock option granting process with our stock option plans and public statements.* Although finding his actions were inconsistent with the duties and obligations of a chief executive officer of a publicly-traded company, the Special Committee also found that Mr. Way's motivation appeared to be the attraction and retention of talent and to provide employees with the best option price. *The Special Committee also concluded that Christopher L. Martin, Executive Vice President and General Counsel, was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document our Compensation Committee's informal delegation of authority to Mr. Way.* The Special Committee also found that there was no evidence that Mr. Way or Mr. Martin intended to falsify the consolidated financial statements.

64. In addition, the Chairman of HCC's Compensation Committee, defendant Lack, resigned back in November 2006:

Before the Board of Directors reviewed the results of the investigation, the Chairman of our Compensation Committee tendered his resignation from the Board of Directors on November 8, 2006. After reviewing the results of the investigation, the Board of Directors determined that it would be appropriate to accept the resignations of Mr. Way and Mr. Martin, which both tendered on November 17, 2006. Mr. Way will remain a director of HCC and serve as the non-executive Chairman of the Board of Directors and has entered into a consulting agreement with us to assist in the transition of leadership and to provide strategic guidance. We have entered into agreements with Mr. Way and Mr. Martin which, among other things, require them to disgorge an amount equal to the difference between the actual measurement date prices determined by HCC and the prices at which these individuals exercised mis-priced options since 1997.

\*\*\*

As a result of the determinations of the Special Committee and because the resulting cumulative charge would be material to the second quarter and full year 2006 consolidated net earnings, we concluded on December 19, 2006 that we needed to amend this Annual Report on Form 10-K for the year ended December 31, 2005 as filed on March 16, 2006 (the Original Filing), to restate our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the related disclosures. However, the impact of the restatement in any of the restated periods is not material. We are making the restatement in accordance with generally accepted accounting principles to record the following:

- Non-cash compensation expense for the difference between the stock price on the stated grant date and the actual measurement date and for the fluctuations in stock price in certain instances where variable accounting should have been applied;
- Other adjustments that were not recorded in the originally filed financial statements due to their immateriality; and
- Related tax effects for all items.

65. The Company also admitted that it “did not maintain an effective control environment as our controls were not adequate to prevent or detect management override by certain former members of senior management related to our stock option granting practices and procedures.”

**APPLICABILITY OF PRESUMPTION OF RELIANCE FOR DEFENDANTS’  
OMISSIONS OF MATERIAL FACTS AND/OR UNDER THE FRAUD ON THE  
MARKET DOCTRINE**

66. The market for HCC’s securities was open, well-developed and efficient at all relevant times. As a result of these materially false and misleading statements and

failures to disclose, HCC's common stock traded at artificially inflated prices during the Class Period. The artificial inflation continued until at least the end of the Class Period. Plaintiff and other members of the Class purchased or otherwise acquired HCC securities relying upon the integrity of the market price of HCC's securities and market information relating to HCC, and have been damaged thereby.

67. During the Class Period, defendants materially misled the investing public, thereby inflating the price of HCC's securities, by publicly issuing false and misleading statements and omitting to disclose material facts necessary to make defendants' statements, as set forth herein, not false and misleading. Said statements and omissions were materially false and misleading in that they failed to disclose material adverse information and misrepresented the truth about the Company, its business and operations.

68. At all relevant times, the material misrepresentations and omissions particularized in this Complaint directly or proximately caused or were a substantial contributing cause of the damages sustained by plaintiff and other members of the Class. As described herein, during the Class Period, defendants made or caused to be made a series of materially false or misleading statements about HCC's business, prospects and operations. These material misstatements and omissions had the cause and effect of creating in the market an unrealistically positive assessment of HCC and its business, prospects and operations, thus causing the Company's securities to be overvalued and artificially inflated at all relevant times. Defendants' materially false and misleading statements during the Class Period resulted in plaintiff and other members of the Class purchasing the Company's securities at artificially inflated prices, thus causing the damages complained of herein.

## **LOSS CAUSATION**

69. Defendants' wrongful conduct, as alleged herein, directly and proximately caused the damages suffered by plaintiff and the Class.

70. During the Class Period, plaintiff and the Class purchased securities of HCC at artificially inflated prices and were damaged when the price of HCC common stock declined when the misrepresentations made to the market, and/or the information alleged herein to have been concealed from the market, and/or the effects thereof, were revealed, causing investors' losses.

## **ADDITIONAL SCIENTER ALLEGATIONS FOR PURPOSES OF CLAIMS ONE AND TWO**

71. As alleged herein, defendants acted with scienter in that defendants knew that the public documents and statements issued or disseminated in the name of the Company were materially false and misleading; knew that such statements or documents would be issued or disseminated to the investing public; and knowingly and substantially participated or acquiesced in the issuance or dissemination of such statements or documents as primary violations of the federal securities laws. As set forth elsewhere herein in detail, defendants, by virtue of their receipt of information reflecting the true facts regarding HCC, their control over, and/or receipt and/or modification of HCC's allegedly materially misleading misstatements and/or their associations with the Company that made them privy to confidential proprietary information concerning HCC, participated in the fraudulent scheme alleged herein.

72. Defendants were personally motivated to engage in the wrongdoing herein in order to make their option grants more valuable and to sell their personally held HCC stock at prices that were artificially inflated by defendants' false statements. Defendant Way sold over 1.7 million shares, grossing more than \$57 million. Defendant Lack sold 50,000

shares for over \$1.4 million. Defendant Ellis sold 60,000 shares for \$2.3 million, and defendant Martin sold 20,706 shares for \$676,000.

29-Dec-06	WAY STEPHEN L	-275,000	32.09	-8,824,750.04
28-Dec-06	WAY STEPHEN L	-150,000	31.84	-4,776,000.02
28-Dec-06	WAY STEPHEN L	-135,000	31.85	-4,299,750.05
27-Dec-06	WAY STEPHEN L	-155,000	32.17	-4,986,349.72
27-Dec-06	WAY STEPHEN L	-200,000	32.23	-6,445,999.91
31-Mar-06	WAY STEPHEN L	-202,500	34.61	-7,008,525.12
30-Mar-06	WAY STEPHEN L	-100,000	34.4	-3,440,000.15
29-Mar-06	WAY STEPHEN L	-47,500	34.66	-1,646,349.99
4-Aug-05	WAY STEPHEN L	-118,000	27.79	-3,279,220.11
3-Aug-05	WAY STEPHEN L	-153,437	28.48	-4,369,885.69
24-May-05	WAY STEPHEN L	-200,000	40.19	-8,037,999.73
		<b>No. of Shares</b>	<b>Price</b>	
		<b>1,736,437</b>	<b>p/s</b>	<b>Total \$57,114,831</b>
17-Mar-06	LACK WALTER JOHN	-12,300	33.25	-408,975.00
14-Feb-06	LACK WALTER JOHN	-7,700	33.25	-256,025.00
19-Aug-05	LACK WALTER JOHN	-30,000	27.05	-811,499.98
		<b>No. of Shares</b>	<b>Price</b>	
		<b>50,000</b>	<b>p/s</b>	<b>Total \$1,476,500</b>
		<b>No of Shares</b>	<b>Price</b>	
10-May-05	ELLIS EDWARD H JR	<b>60,000</b>	<b>38.62</b>	<b>Total \$2,317,199.94</b>
		<b>No. of Shares -</b>	<b>price</b>	
11-Nov-05	MARTIN CHRISTOPHER LYN	<b>20,706</b>	<b>32.66</b>	<b>Total \$676,257.96</b>

73. In addition, the wrongdoing allowed HCC to profit by selling stock in a follow-on offering. On November 22, 2005, HCC sold 4,687,500 shares of HCC common stock at \$32.05 per share, a price higher than if the Company's financial results were not artificially inflated.

## **FIRST CLAIM**

### **VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST ALL DEFENDANTS**

74. Plaintiff repeats and realleges each and every allegation contained above as if fully set forth herein.

75. During the Class Period, HCC and the Individual Defendants, and each of them, carried out a plan, scheme and course of conduct which was intended to and, throughout the Class Period, did: (i) deceive the investing public, including plaintiff and other Class members, as alleged herein; (ii) artificially inflate and maintain the market price of HCC's securities; and (iii) cause plaintiff and other members of the Class to purchase HCC's securities at artificially inflated prices. In furtherance of this unlawful scheme, plan and course of conduct, defendants, and each of them, took the actions set forth herein.

76. Defendants (i) employed devices, schemes, and artifices to defraud; (ii) made untrue statements of material fact and/or omitted to state material facts necessary to make the statements not misleading; and (iii) engaged in acts, practices, and a course of business that operated as a fraud and deceit upon the purchasers of the Company's securities in an effort to maintain artificially high market prices for HCC's securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5. All defendants are sued either as primary participants in the wrongful and illegal conduct charged herein or as controlling persons as alleged below.

77. In addition to the duties of full disclosure imposed on defendants as a result of their making of affirmative statements and reports, or participation in the making of affirmative statements and reports to the investing public, defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance with the

integrated disclosure provisions of the SEC as embodied in SEC Regulation S-X (17 C.F.R. Sections 210.01 *et seq.*) and Regulation S-K (17 C.F.R. Sections 229.10 *et seq.*) and other SEC regulations, including accurate and truthful information with respect to the Company's operations, financial condition and earnings so that the market price of the Company's securities would be based on truthful, complete and accurate information.

78. HCC and the Individual Defendants, individually and in concert, directly and indirectly, by the use, means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal adverse material information about the business, operations and future prospects of HCC as specified herein.

79. These defendants employed devices, schemes and artifices to defraud, while in possession of material adverse non-public information and engaged in acts, practices, and a course of conduct as alleged herein in an effort to assure investors of HCC's value and performance and continued substantial growth, which included the making of, or the participation in the making of, untrue statements of material facts and omitting to state material facts necessary in order to make the statements made about HCC and its business operations and future prospects in the light of the circumstances under which they were made, not misleading, as set forth more particularly herein, and engaged in transactions, practices and a course of business that operated as a fraud and deceit upon the purchasers of HCC's securities during the Class Period.

80. Each of the Individual Defendants' primary liability, and controlling person liability, arises from the following facts: (i) the Individual Defendants were high-level executives and/or directors at the Company during the Class Period and members of the Company's management team or had control thereof; (ii) each of these defendants, by virtue of his responsibilities and activities as a senior officer and/or director of the Company was privy

to and participated in the creation, development and reporting of the Company's internal budgets, plans, projections and/or reports; (iii) each of these defendants enjoyed significant personal contact and familiarity with the other defendants and was advised of and had access to other members of the Company's management team, internal reports and other data and information about the Company's finances, operations, and sales at all relevant times; and (iv) each of these defendants was aware of the Company's dissemination of information to the investing public that they knew or recklessly disregarded was materially false and misleading.

81. The defendants had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though such facts were available to them. Such defendants' material misrepresentations and/or omissions were done knowingly or recklessly and for the purpose and effect of concealing HCC's operating condition and future business prospects from the investing public and supporting the artificially inflated price of its securities. As demonstrated by defendants' overstatements and misstatements of the Company's business, operations and earnings throughout the Class Period, defendants, if they did not have actual knowledge of the misrepresentations and omissions alleged, were reckless in failing to obtain such knowledge by deliberately refraining from taking those steps necessary to discover whether those statements were false or misleading.

82. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market price of HCC's securities was artificially inflated during the Class Period. In ignorance of the fact that market prices of HCC's publicly-traded securities were artificially inflated, and relying directly or indirectly on the false and misleading statements made by defendants, or upon the integrity of the market in which the securities trade, and/or on the absence of material adverse information

that was known to or recklessly disregarded by defendants but not disclosed in public statements by defendants during the Class Period, plaintiff and the other members of the Class acquired HCC securities during the Class Period at artificially high prices and were damaged thereby.

83. At the time of said misrepresentations and omissions, plaintiff and other members of the Class were ignorant of their falsity, and believed them to be true. Had plaintiff and the other members of the Class and the marketplace known of the true financial condition and business prospects of HCC, which were not disclosed by defendants, plaintiff and other members of the Class would not have purchased or otherwise acquired their HCC securities, or, if they had acquired such securities during the Class Period, they would not have done so at the artificially inflated prices which they paid.

84. By virtue of the foregoing, defendants have violated Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

85. As a direct and proximate result of defendants' wrongful conduct, plaintiff and the other members of the Class suffered damages in connection with their respective purchases and sales of the Company's securities during the Class Period.

## **SECOND CLAIM**

### **VIOLATION OF SECTION 20(a) OF THE EXCHANGE ACT AGAINST THE INDIVIDUAL DEFENDANTS**

86. Plaintiff repeats and realleges each and every allegation contained above as if fully set forth herein.

87. The Individual Defendants acted as controlling persons of HCC within the meaning of Section 20(a) of the Exchange Act as alleged herein. By virtue of their high-level positions, and their ownership and contractual rights, participation in and/or awareness of the Company's operations and/or intimate knowledge of the false financial statements filed by

the Company with the SEC and disseminated to the investing public, the Individual Defendants had the power to influence and control and did influence and control, directly or indirectly, the decision-making of the Company, including the content and dissemination of the various statements that plaintiff contends are false and misleading. The Individual Defendants were provided with or had unlimited access to copies of the Company's reports, press releases, public filings and other statements alleged by plaintiff to be misleading prior to and/or shortly after these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected.

88. In particular, each of these defendants had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, is presumed to have had the power to control or influence the particular transactions giving rise to the securities violations as alleged herein, and exercised the same.

89. As set forth above, HCC and the Individual Defendants each violated Section 10(b) and Rule 10b-5 by their acts and omissions as alleged in this Complaint. By virtue of their positions as controlling persons, the Individual Defendants are liable pursuant to Section 20(a) of the Exchange Act. As a direct and proximate result of defendants' wrongful conduct, plaintiff and other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

### **THIRD CLAIM**

#### **Violation of §14(a) of the Exchange Act and Rule 14a-1 to 14a-9 for the Proxy Statement Against All Defendants**

90. Plaintiff repeats and realleges allegations contained in paragraphs 1 to 73, as if fully set forth herein, excluding any and all allegations that contain facts necessary to prove any element not required to state a §14(a) claim.

91. This Claim is brought pursuant to Section 14 of the Exchange Act on behalf of HCC were shareholders of record on April 3, 2006.

92. Defendants caused the Proxy Statement to be issued and distributed to shareholders of HCC in order to solicit their approval of the election of the board of

93. The Proxy Statement was a “proxy solicitation” within the meaning of Section 14 of the Exchange Act.

94. The 2004 Proxy Statement was false and misleading in that it contained false and misleading statements of material facts and failed to disclose material facts necessary to make the statements made not false and misleading as described above at ¶¶ 52.

95. Defendants sought to secure shareholder approval of the Company’s proposed directors elections by means of the materially false and misleading Proxy Statement and permitted the use of their names to solicit proxies from the members of the Proxy Subclass.

96. Each of the misstatements and omissions described above at ¶¶ 50-51 was material to the determination by the shareholders of whether or not to grant or withhold their proxy.

97. Defendants, at the time they issued or caused to be issued the Proxy Statement, acted negligently in distributing and causing to be distributed the Proxy Statement containing the false and misleading statements and omissions.

98. As a result of the foregoing, Defendants violated Section 14(a) of the Exchange Act and Rules 14a-1 to 9 promulgated thereunder.

99. Shareholders of record on April 3, 2006, have sustained injury and damages by reason of Defendants’ misrepresentations in connection with the Proxy Statement.

100. **WHEREFORE**, plaintiff prays for relief and judgment, as follows:
- a. Determining that this action is a proper class action and appointing plaintiff as Lead Plaintiff and its counsel as Lead Counsel for the Class and certifying it as a class representative under Rule 23 of the Federal Rules of Civil Procedure;
  - b. Awarding compensatory damages in favor of plaintiff and the other Class members against all defendants, jointly and severally, for all damages sustained as a result of defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;
  - c. Awarding plaintiff and the Class their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and
  - d. Such other and further relief as the Court may deem just and proper.

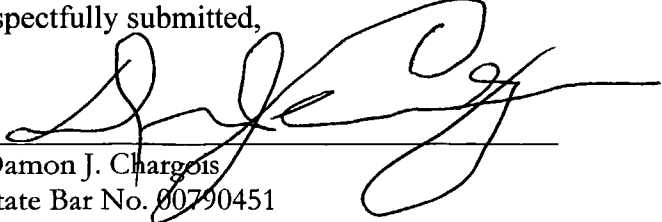
**JURY TRIAL DEMANDED**

Plaintiff hereby demands a trial by jury.

DATED: March 7, 2007

Respectfully submitted,

By

  
Damon J. Chargois  
State Bar No. 00790451  
2201 Timberloch Place, Suite 110  
The Woodlands, Texas 77380  
Telephone: (281) 444-0604  
Facsimile: (281) 440-0124  
ATTORNEY IN CHARGE

OF COUNSEL:  
CHARGOIS, MASHAYEKH & HERRON, LLP

**LABATON SUCHAROW & RUDOFF LLP**

Christopher J. Keller

Andrei V. Rado

Alan I. Ellman

100 Park Avenue

New York, New York 10017

Telephone: (212) 907-0700

Facsimile: (212) 818-0477

ATTORNEYS FOR PLAINTIFF

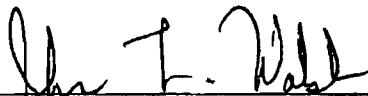
**CERTIFICATION**

I, John Walsh as Director of Operations of Bristol County Retirement System

("Bristol County"), hereby certify as follows:

1. I am fully authorized to enter into and execute this Certification on behalf of Bristol County. I have reviewed a complaint prepared against HCC Insurance Holdings Inc. ("HCC") alleging violations of the federal securities laws;
2. Bristol County did not purchase securities of HCC at the direction of counsel or in order to participate in any private action under the federal securities laws;
3. Bristol County is willing to serve as a lead plaintiff in this matter, including providing testimony at deposition and trial, if necessary;
4. Bristol County's transactions in the securities of HCC as reflected in Exhibit A, are attached hereto;
5. Bristol County has not sought to serve as a lead plaintiff in a class action under the federal securities laws during the last three years;
6. Beyond its pro rata share of any recovery, Bristol County will not accept payment for serving as a lead plaintiff on behalf of the class, except the reimbursement of such reasonable costs and expenses (including lost wages) as ordered or approved by the Court.

I declare under penalty of perjury, under the laws of the United States, that the foregoing is true and correct this 28<sup>TH</sup> day of February, 2007.

  
\_\_\_\_\_  
John Walsh  
Director of Operations